

Financial Monitor:

Analysis of the key reforms in Moldova's financial sector

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1. Introduction

After over three years since the banking crisis, the national financial system keeps undergoing a large-scale reform process that registers an extension to all his components. Following the immediate stabilizing measures aimed at alleviating the situation of the banks and resuming financial cooperation with key external partners, a number of other actions were launched aiming to strengthen the stability and to role of the financial system in the economy. Most actions represent the commitments taken within the Memorandum with the International Monetary fund (IMF) or within the EU Association Agreement, commitments that are a catalysing factor for the reforms and on which the further allocation of financial support for our country depends. Even so, in order to ensure the expected result, Moldova needs tangible progress in other sectors such as energy or justice as well, and the EU macrofinancial assistance freeze confirms that the current problems cannot be approached in an isolated manner only from the perspective of the banking sector anymore.

Starting with 2016, Expert-Grup has pledged to permanently monitor the activity of line authorities in the national financial system reform process. In this context, Financial Monitor nr. 7 points out the key legislative or regulatory measures implemented (or not implemented) by the authorities during October 2017 – July 2018, as well as other developments describing the *de facto* state of the financial system. In comparison with other sectors, the banking one remains one of the most dynamic in terms of reform implementation, resulting from the implementation of the new banking regulatory and supervision framework according to the Basel III agreement. Likewise, other measures aiming towards finalizing the process of improving transparency regarding bank shareholders or towards the prevention and combating money laundering have proven the priority. At the same time, the reforms have covered the other sectors of the financial market, especially the non-bank lending sector which registers a certain tightening (however insufficient) of the regulatory level.

The monitoring exercise covered the following major actions identified in the reference period:

- Transition to the new banking regulatory and supervision framework aligned with Basel III standards;
- The adjustment of legislative framework related to transparency of bank shareholders;
- The adoption of the Law on non-bank credit organizations;
- The adoption of the new Anti-Money Laundering framework;
- Fulfilling the commitments taken within the framework of international Agreements.

Besides these, a series of other events that actively manifested and characterise the general situation of the financial system were analysed. This is the financial intermediation process that besides the tendency of the demand to shrink and migrate to sectors other than the banking one, it poses possible risks of over-indebtedness for certain segments of clients. Thus, against the backdrop of less transparent and even abusive lending practices, a low level of protection for individual consumers is registered. Without any interventions, this situation could lead to a deterioration in consumer loan repayment capacity and an increase in non-performing assets for financial institutions.

Not lastly, in the absence of tangible results on the banking fraud investigation process, the line bodies presented a Strategy describing the procedure of the stolen means recovery process. This is, basically, not a strategy for the investigation bodies, as they know fairly well how to proceed. It is actually a document for the population which after the Kroll investigation reports needs a new reference point in this case of increased interest. In the meantime, beyond this media coverage of the fraud investigation plan, the effective recovery of stolen money does not register significant progress, a first instalment to repurchase State Securities issued by the Ministry of Finance being allocated, including from public money.

2. The transition to the new banking regulatory framework - Basel III

Together with the adoption of the new banking law, the national regulatory and supervision framework leaps towards the most modern and best practices existing at international level, also known as the Basel III standards. From the perspective of recent developments, their implementation will incur a certain delay, but such a step could have been taken only under clear political consensus, a stable banking system and a solid external support. Thus after the banking crisis revealed a series of vulnerabilities, Basel III comes with solutions and tools that are much more adapted from legal perspective in terms of regulator capacity of intervention, as well as prudential perspective – at the level of commercial banks in terms of adequate risk management, prevention of destabilizing elements and strengthening people's confidence.

The transition to Basel III comes after a period of recovery in the banking system which lead to broad developments in the balances of banks. From an economic and financial point of view, the transitions process finds the banking sector characterized by excess liquidity that hardly finds its counterpart in the real economy (the volume of loans represents only about 30% of the total banking assets). Also, although the inflation rate dropped under the 5% target the NBM aimed for, banking loans still remain expensive, with effective interests of over 10%-12% annually, which limits the interest of wider group of clients. On this backdrop, at the end of 2017, the banking intermediation registers one of the lowest levels in the past 10 years: the total loans balance reported to GDP was of 24%. Even so, on both individual and aggregated level, the banking sector remains quite profitable, which increases the capital reserves, as well as the bank capacity to absorb eventual losses or to cope with the tightening regulatory framework.

The Basel III Agreement provisions are to be implemented gradually by the commercial banks which have transition periods at their service depending on the specific sector approached and the scale of their activity. Thus, the main news emerges in areas such as capital adequacy, affiliate transactions, risk assessment and management, corporate governance, sanctions, and other specificities of banking activity. Ambitious on one hand, extremely necessary on the other, the Basel III standards implementation process is a challenge both for commercial banks and their clients, and the regulator. For banks and economic operators seeking financing, the rules become much more strict and with significant implications for the business model and even profitability. For the regulator, the scale of the process continues to indicate the importance of strengthening operation, technical and human capacity for an efficient implementation on the new legislation. In this context, in order to transpose Basel III into the national legislation, over the course of 2018, NBM, with the support of external partners, approved a series of Regulations the provisions of which are listed below.

2.1. Additional capital requirements

The Basel III Agreement introduces extensive quantitative and qualitative capital requirements, that would allow eventual losses, especially during crisis periods. Since the bank's own funds (social capital, reserves, profit, subordinated loans) are the element that ensures the bank activity financing in order to ensure its continuity, as well as covering losses at any moment, it becomes imperative that they are correctly calculated and maintained at acceptable levels. Thus, in the context of transposing the CRD IV¹ European bank regulation framework which implements the Basel III Agreement, NBM developed two new regulatory documents: (i) *The Regulation on bank own funds and capital requirements* and (ii) *The Regulation on bank capital buffers*.

(i) **The Regulation on bank own funds and capital requirements** - includes a new own funds calculation methodology and establishes requirements towards the elements that are part of the calculation, as well as deductions

¹ Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and Regulation 575/2013 on prudential requirements for credit institutions and investment firms.

and reductions that may occur. At the same time, the Regulation includes the concept of Tier 1 and Tier 2 capital and total capital (to a certain extent these replace the Total Regulatory Capital), the elements eligible for their calculation and prudential filters applicable in order to eliminate elements generating an artificial increase. At the same time, a series of elements to be deducted from own funds in order to avoid double use of regulated capital and/or its artificial increase are established. Lastly, the own funds requirements are presented, namely: Common Equity Tier 1 capital ratio of 5.5%, a Tier 1 capital ratio of 7.5%; and a total capital ratio of 10.0%. Also, other risks are included in own funds calculation, such as the operational, market and settlement/delivery risks.

In practical terms, a stronger emphasis is placed on the level of capital available for covering several types of bank activity, not just lending. Additionally, with the revision of the risk-weighted assets structure (pt. 2.2 means representing safer assets have a lower capital allocation, while assets with a higher risk level get a higher weight depending on the risk. This means that prudential rules will tighten, which is good from risk management perspective but not as good for increasing financial intermediation, because banks will become much more cautious in granting loans or will even give up some clients who will significantly impact the capital needs. Moreover, from the perspective of a decreasing number of clients that become „bankable” in the context of Basel III, other economic and fiscal reforms at company level are necessary in order to increase their capacity to comply with bank requirements. Basically, the economy needs solid banks in order to develop, and similarly, banks need solid and thriving businesses in order to be able to grant loans.

(ii) The Regulation on bank capital buffers – provides for the setting up of capital buffers in order to prevent and mitigate systemic risk, as well as the particularities associates with NBM establishing the calculation methodology. Essentially, 5 buffers are foreseen: *capital conservation*; *anti-cyclic capital specific to each bank*; *O-SII*; *systemic risk and combined*. There is a series of restrictions that NBM can impose on banks that do not comply with the established buffer requirements, such as restrictions on distribution of dividends and other requirements including a capital conservation plan if the bank does not have a sufficient level of own funds to allow compliance with the requirements of capital buffers (capital conservation measures).

- **the capital conservation buffer** – aims to create a capital reserve in „calm” periods (recession periods);
- **the anti-cyclic capital buffer specific to each bank** – aims to increase the banking sector resilience to potential losses induced by an excessive lending increase and is created during excessive lending increase periods as an addition to the capital conservation buffer;
- **the O-SII buffer** – is specific to each entity of systemic importance at national level the bankruptcy or faulty operation of which could trigger a national level systemic risk;
- **the systemic risk buffer** – is applied to prevent and reduce the non-cyclic systemic risk manifested long-term or the macro-prudential risk;
- **the combined buffer** – consists of the capital conservation buffer, plus, case by case, the anti-cyclic capital buffer specific to each bank, the O-SII and systemic risk buffers.

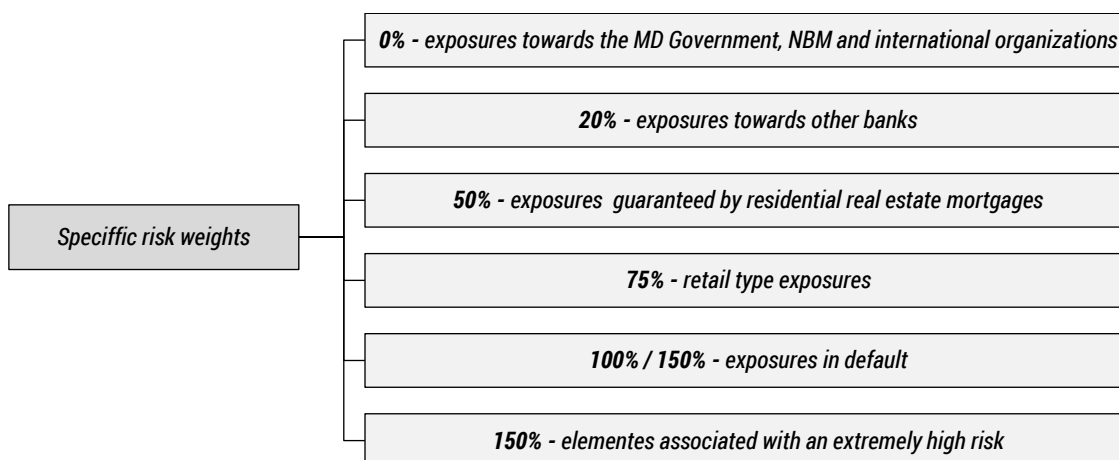
Thus, besides the mandatory requirements towards own funds, all banks should have a capital conservation buffer and an anti-cyclic capital buffer, to make sure that they accumulate sufficient own funds in thriving periods, and can, accordingly, absorb losses if a crisis occurs. This protection solution using the capital, derives from the fact that the losses incurred during crises can destabilize the banking system and initiate a vicious circle, through which all bank problems can lead to a recession of real economy, which in turn impacts the banks by increasing the amounts of non-performing loans. Thus, the capital buffers are to ensure that banks have enough capital to maintain their lending activity during crisis periods as well. However, the buffers may lead to an increase of loan costs when the portfolio reaches an excessive level and the capital is the most expensive financing source.

2.2. Assessment of the credit risk

Another component of the Basel III framework regards the approval of new credit risk management regulations. In connection to this, on July 30th *The credit risk standardised approach treatment Regulation* will enter into force, a normative act establishing the components of exposure weight calculation based on the credit risk degree assumed by the bank. Thus, the Regulation emphasises 16 classes of exposures the weight of which incorporate various degrees of sensitivity to risk, from 0% to 150%, including external ratings given by credit rating agencies. With respect to the NBM concept on using rating agencies, it only refers to the agencies registered based on the European Regulation² and does not take into consideration the NFMC efforts to transpose it into the national legislation according to the EU AA commitments taken. Respectively, for the time being, the NBM Regulation on the standardized approach treatment does not take into account the possibility that in our country such agencies providing credit risk assessment for national entities may emerge, giving banks more options in the internal process of credit risk assessment and management.

Unlike the 100% limit up until now, the Regulation comes with a series of extended requirements on exposure classification and provides the application of a risk weight of 150% for those involving an extremely high risk (figure 1). This is explained by the fact that a compromised asset, besides losing its value, may in addition lead to losses from legal perspective or may affect the bank reputation. At the same time, for certain sectors such as exposures towards SMEs, the Regulation provides reduced capital requirements by establishing a risk weight of 75% for exposures in amount of up to MDL 5 mil. and by applying a deduction factor equal to 0,7619 for debtor's aggregated exposure in amount of up to MDL 7.5 mil. Ultimately, considering the specific of the national real estate market, for exposures guaranteed fully and in full by mortgages on residential and commercial real estate, the Regulation provides a weight of 50% and 75% accordingly.

Figure 1. Specific weights for credit risk assessment (examples)



Source: Author's compilation based on the Regulation on the standardized approach to treating bank credit risk

2.3. Corporate governance and qualification of management body members

The Basel III agreement brings new elements regarding corporate governance and qualification of individuals who can hold positions in management bodies. Starting from the notion that customer confidence, depositor security and the overall stability of the banking system can only be ensured through sound corporate governance, the new Banking Law comes with new elements in this respect. These changes are extremely important as the banking crisis has revealed a number of serious shortcomings in the management process of several banks, including credit decisions, the work of the executive body or reduced transparency of shareholders that compromised the identification of relationships with

² Regulation (CE) nr. 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies is to be transposed into the national legislation according to the EU Association Agreement commitments.

affiliated parties and proper management of conflicts of interest. Thus, from the lessons learned, we can say that the failure of bank administrators to comply with good corporate governance practices can jeopardize the bank's solvency and affect the interests of a broad range of stakeholders.

Corporate governance for banks must be seen as a necessity that would force bank managers to protect the interests of all stakeholders while at the same time proving a responsible behaviour and attitude. The Regulation on bank activity management framework³ clearly defines the bank management bodies, namely the Board and the Executive Committee, as well as provisions for the creation of specialized board committees to assist it in carrying out its tasks in the process of risk management. Also, an important aspect, the legislative framework ensures for the delimitation of the responsibilities of each management body and requirements for the individual, as well as collective suitability of the members. Moreover, because shareholders are an important element of the governance mechanism, the regulatory framework establishes how they interact with management bodies and the requirements towards the policy for managing potential conflicts of interest. These requirements are to be gradually implemented by all commercial banks, depending on the size and complexity of their activity, sanctions and remedial measures being provided for those who will not comply.

To ensure sound banking activity, corporate governance principles are complemented by specific requirements for the suitability of management body members at both individual and collective levels. Thus, senior management and other key personnel⁴ must at all times have expertise, reputation and professional quality in accordance with their job duties, or in other words, in the evaluation process they must successfully show that they are a "fit & proper" person. In general terms, the suitability assessment of management body members aims at forming a comprehensive picture of the character of a person based on criteria of experience, reputation, independence in decision making, sufficient time allocation and how well they fit in the management body. At the moment, once the legislative framework has been approved, both NBM and banking institutions should aim to eliminate all people with compromised image and bad reputation in the banking system, subsequently, the regular assessment of "fit & proper" is to become a solid barrier to accession of people with dubious intentions at the management of commercial banks.

2.4. Limiting transactions with affiliated parties

Together with other economic activities, relationships with affiliated parties are also characteristic to the banking business and are transactions occurring between persons related through certain relationships or association. The importance of the correctly managing this type of relationship derives from the need to mitigate risks that banks may be exposed to when these may generate conflicts of interest and affect the managers' independence in the decision-making process. Under these circumstances, the Basel III Agreement pays increased attention to this type of relationship by proposing extensive identification and evaluation procedures. At the same time, taking into account that the crediting of affiliated persons was until recently a common characteristic for the domestic banking sector (shareholder lending in particular), the NBM extended its regulations in this field improving the characteristics used to identify affiliated persons.

Amendments to the Regulation on bank transactions with its affiliated parties come to strengthen the position of banks managing this type of relationship. Thus, transactions with persons for whom the lack or existence of affiliation cannot be established or verified became prohibited, this being one of the key elements of the banking crisis in the context when reduced shareholder transparency facilitated granting loans to persons who were actually affiliated with the bank. Also, non-compliance with the 10% limit of the Total Regulatory Capital or 20% of the Tier 1 capital against the bank's total exposure to an affiliated person may result in the deduction of amounts exceeding that limit from the bank capital, thus reducing the bank capital. Moreover, when establishing internal policies and procedures, commercial banks shall take into

³ Law nr. 202 as of 06. 10. 2017 on bank activity and The Regulation on bank activity management framework approved by NBM Decision BNM nr. 146 as of 07.06.2017.

⁴ Key personnel – personnel members whose functions give them a significant influence on the direction of the bank, but who are not members of the management body. Among key personnel can be the managers of important lines of activity, branch offices, of support and control functions.

account the nature, scale and complexity of the risks associated with transactions with affiliated persons while respecting the principles of prudence, ethics, transparency, governance, accountability and good repute.

3. Other reforms to strengthen the national financial sector

3.1. Adjustment of the legislative framework related to transparency of bank shareholders

One of the priority actions in the context of reforming the domestic banking system is increasing ownership structure transparency for all banks and knowing the shareholders up to the ultimate beneficiary. Following the measures to assess and increase shareholder transparency undertaken in the period 2016-2017, which focused on the largest banks in the sector, the current year registers and expansion over to medium and small banks whose shareholders have not complied with the established requirements. Directly, the sanctions imposed on banks lately confirm the non-compliance with banking legislation requirements, including those regarding transparency and shareholder quality. In the context of the shareholder assessment, their quality extends to two key elements: (vi) transparency and (vii) financial stability and soundness.

(i) **transparency** – one of the most important features of shareholders of financial institutions, requires exact knowledge of the final beneficiaries of these actions, namely who determines the direction of activity of the financial institution and ultimately collects the profit. Also, knowing the real shareholders is important from the point of view of establishing a clear relationship between the financial institution and the ultimate beneficiary (the credits volume to affiliated persons, the existence of conflicts of interests, etc.), generally establishing the „fit & proper” status, and holding the exact persons accountable if necessary;

(ii) **financial soundness** – since financial business can have far greater implications for a large number of people, it is important that the shareholders of such an institution manage their financial resources in a fair and transparent manner and have a sound financial position in order to support the institution with additional capital in crisis situations.

In addition to the efforts to increase transparency, reform actions also aimed to unblock the alienation of share packages at the largest banks in the sector. After NBM blocked the rights of some shareholders to the first two largest banks in the sector (BC Moldindconbank and BC Moldova-Agroindbank), the alienation process has reached a deadlock due to the lack of a detailed procedure for the cancellation, issuance and sale of shares held without compliance with the requirements regarding the quality and transparency. To this end, in order to ensure the existence of a legal framework expressly establishing the sale stages for newly issued shares, the criteria for determining price, the terms of sale, as well as the manner of compensation for former shareholders, amendments and additions were operated to the Law on bank activity. They regulate the stages of sale procedure, the latter being the alienation of newly issued shares in fractional packages according to the regulated market rules or the multilateral trading system. Thus, two distinct situations are outlined: (i) the newly issued shares have not been sold and they represent at least 50% of the bank's social capital and (ii) the newly issued shares have not been sold and represent less than 50% of the bank's social capital.

(i) **the shares represent at least 50% of the bank's social capital** - if the bank is of systemic importance and a resolution action is necessary from the public interest perspective, NBM may take one of the resolution actions provided by the Law on bank recovery and resolution⁵. Otherwise, NBM withdraws the license granted to the bank without applying the forced liquidation process provided by the Law on financial institutions⁶.

(ii) **the shares represent less than 50% of the bank's social capital** – the bank redeems the unsold shares in accordance with the prudential requirements for own funds (capital adequacy), depositing their monetary value in the former shareholders' account. However, the redeemed shares are treasury shares and may not exceed 10% of the social

⁵ Law nr. 232 as of 3 October 2016 on bank recovery and resolution

⁶ Law on financial institutions nr.550-XIII as of 21 July 1995

capital, i.e. those exceeding this limit are to be cancelled decreasing the bank's social capital and issuing the subordinated debt to former holders.

Another part of the reform to increase bank shareholder transparency is to attract foreign investors of good quality and with a strong financial position. However, to date, among banks with shareholder transparency problems, it was possible to attract a strategic investor with good reputation only at B.C. Victoriabank. It is the Banca Transilvania Romanian bank, which decided to acquire a 39.2% stake, and together with the European Bank for Reconstruction and Development currently hold about 72% of B.C. Victoriabank. On the other hand, for B.C. Moldova-Agroindbank (MAIB) and B.C. Moldindconbank (MICB) the process advances much more slowly. In the case of MAIB, the intention to acquire the 41.09% stake was confirmed by an international consortium of several investors⁸. Under Art. 54¹ of the Law on public property management and privatisation⁹, the sale and purchase procedure are a special one, and it provides as an intermediate measure that the state takeover the shares and subsequently sell them to a potential investor, while avoiding the bank decapitalisation.

3.2. The Law on non-banking credit organizations

The intention to strengthen the supervision and regulation level of the microfinance sector dates back to 2012 when a draft law on non-bank credit organizations (NCOs) was drafted and promoted. However, the legislative procedure was blocked at Parliament level since the necessary consensus for the debate and adoption of the draft has not been achieved. However, given the fact that the microfinance sector has reached a high degree of growth following the migration trend of credit demand from the banking sector, it becomes essential to establish a new vision, especially in terms of regulation, prevention of excessive risks and consumer protection. For example, analysing the structure of the financial intermediation process, there is a sharp increase in the share of the NCOs determined both by the rapid increase of their portfolio and by the continuous decrease of the portfolio of loans granted by banks (at the end of 2017 the share of the NCO portfolio was around 17% compared with only 7% in 2013). In this respect, during 2017, in cooperation with external partners, the Law on non-bank credit organizations was promoted and adopted. It is due to enter into force on 1 October 2018, replacing the current Law on microfinance organizations and giving the participants time to comply.

By defining the term "non-bank credit" the law extends its applicability to the sector of leasing companies. Thus, the NCO is entitled to professionally perform only non-banking lending activities which are represented by the granting of non-bank loans and financial leasing. Other important aspects of the law are: (i) the establishment of minimum capital requirements in the amount of MDL 300 thousand; (ii) the establishment of restricted activities, namely attracting deposits or other repayable funds from individuals; (iii) requirements towards managers, (iv) the obligation to audit annual financial reports; (v) expanding the NCFM role in the supervision process and (vi) the possibility of applying sanctions. Also, prudential requirements were established for NCOs, i.e. the obligation to hold and maintain own capital in relation to the value of assets at any given date of at least 5%.

Although the adoption of the Law on non-bank credit organizations is an important step in the consolidation of the sector, a number of problems continue to persist. A major problem remains the attraction of deposits or other repayable funds from individuals even if it is not evident in direct form. These are different types of reimbursable financing (e.g. capital contribution, undistributed dividends, loans made through legal entities) which ultimately belong to natural persons and

⁷ **subordinated debt** – a loan that cumulatively meets a number of criteria: (it is not guaranteed, the maturity is at least 5 years, the granting terms do not contain any incentive for early repayment by the bank, the provisions governing subordinated debt do not indicate explicitly or implicitly that the subordinated debts will be or could be repaid early by the bank in cases other than bank liquidation; in the event of bank liquidation, it shall be paid after all bank credit or claims have been executed but prior to the execution of shareholders claims, of former holders of share in the bank social capital, to which the measures provided for by law with respect to the cancellation and issuance of new shares were ordered, if they hold a claim against the bank resulting from the cancellation of the shares held by them and subordinated debt holders);

⁸ The consortium consists of Banca The European Bank for Reconstruction and Development, Horizon Capital, The International Financial Corporation, The Dutch Development Bank, The German Investment Corporation, The French Development Agency, and Invalda INVL.

⁹ Law nr. 121 as of 04.05.2007 on public property administration and privatization

for which there is no bankruptcy protection and guarantee scheme. Thus, from the perspective of maintaining personal and collective financial stability, it is important to clearly define and supplement the law with the types of reimbursable financing that should be banned in the context of NCO activity. Priority should also be given to closely monitoring the volume of funding attracted by the NCOs, both in hidden form from individuals and from certain types of legal entities (SMEs and other less sophisticated entities), and improving the collection process of data from all market representatives.

In addition, to support the stability of the financial system and to avoid uncontrolled growth of the non-banking credit sector, a solid secondary normative framework of regulation and supervision is needed. This also means the tools to assess key personnel competences and reputation, as well as shareholder transparency (fit&proper standards); sanction tools that should be able to discourage any fraudulent and risky behaviour of administrators and to correct the NCO business model as well as a crisis prevention and insolvency intervention mechanism (early intervention or resolution tools). Moreover, as the main beneficiaries of non-bank loans are individuals without a thorough financial education, the NCFM, together with the Consumer Protection and Market Surveillance Agency (CPMSA), should carefully monitor the lending practices used, preventing possible abuses and ensuring the protection of financial service consumers. Last but not least, the rapid evolution of the non-bank lending sector may amplify the risk of population over-indebtedness and financial situation deterioration. In this respect, it is essential to extend the list of organizations that are required to provide information to the Credit History Office, thus ensuring that the real situation regarding borrower exposures to different financial market sectors is known.

3.3. The new AML framework

The recent cases of money laundering through domestic banks showcase the destructive effect on the financial system, the integrity of state institutions and the economy as a whole. For Moldova, money laundering has become a hot topic in the context of the Laundromat case and the frauds at Banca de Economii resulting in a millions of dollars fraud. The involvement of politically exposed people, high-level corruption, financial means gained through fraud, or the use of off-shore entities are only the most important elements that allowed the creation and activation of complex money-laundering mechanisms using the national banking system.

With the signing of the European Union Association Agreement, Moldova has undertaken the commitment to align anti-corruption and money laundering prevention legislation with the latest European practices in the field. At the same time, our country has taken the obligation towards several international institutions to strengthen the money laundering prevention and combating framework, area under special monitoring by the MONEYVAL¹⁰ Committee and the International Monetary Fund as well. As a result, after several delays, the Parliament adopted on 22 December 2017 in final reading the draft Law on prevention and combating money laundering and terrorism financing¹¹. It generally complies with the EU Directive 2015/849 as well as with the latest FATF recommendations, which are also the most advanced regulatory framework for this phenomenon's prevention and combating. The novelty of the new law consists in detaching the Money Laundering Prevention and Combating Service from the control of the NAC and transforming it into an independent public authority that functions as an autonomous and independent central specialized body.

Although we have a law transposing the latest money-laundering practices, there are currently a number of weaknesses at the level of responsible institutions which create premises for the persistence of the phenomenon. That is showcased by the numbers in the annual report that confirm that the temptation to use the national financial system as a legalization and transit platform for dubious funds remains quite high¹². At the same time, although we have a theoretically functional

¹⁰ Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism

¹¹ Law Nr. 308 as of 22.12.2017 on money laundering prevention and combating and financing of terrorism

¹² For example, in 2016, about 600,000 forms containing transactions assessed as suspicious came to the MLPCS from reporting entities. Out of these, 236 files were sent to the criminal prosecution bodies (Prosecutor's Office and NAC), 19 to the Main State Tax Inspectorate, 22 to financial

law, significant delays are recorded in the approval of the secondary law enforcement framework, in particular the application of proportionate and dissuasive sanctions for reporting entities in confirmed cases of money laundering. Also, other institutions with complementary responsibilities that should to close the corruption and money laundering prevention chain still have some shortcomings. This is the National Integrity Agency whose activity is affected by an insufficient budget, and the Agency for Criminal Goods Recovery, which does not show any clear results, although there is a significant number of financial investigations.

4. Fulfilling the commitments taken within International Agreements

4.1. The Memorandum with the International Monetary Fund

Starting with the end of 2016, Moldova has a Memorandum of Cooperation on economic and financial policies with the IMF. The poor condition the financial and banking sector ended up in, has come to prove once again that besides financial support, Moldova also needs a continuous monitoring of the financial policies. The experience of 2012-2015 shows that a situation without a functional Agreement with the IMF correlated with the on-going political crisis is a dangerous combination for the country economy and security. Based on what has happened, the Government has committed to implement a comprehensive reform program that is firmly aimed at strengthening economic governance and transparency, as well as reducing other existing risks.

In the spring of this year, the third evaluation mission to assess the program originally agreed took place and was finalized with an allocation of USD 33.8 million. Overall, the evaluation recognizes Moldova's strong commitment to the reforms undertaken, which contributes to strengthening the economy. Nevertheless, it is essential that the policies applied are prudent and the reforms continue towards strengthening the banking sector, ensuring the energy sector transparency and maintaining macroeconomic stability. The main actions for the immediate period are related to: (i) lifting the temporary administration at the second largest bank in the sector (the early intervention regime at MICB); (ii) identifying and eliminating all incompliant shareholders in all commercial banks; (iii) addressing the issue of exposures to affiliated parties including plans to eliminate excessive exposures, (iv) improving bank risk management procedures to allow effective financial intermediation. A greater focus is also placed on the financial and non-banking sector, especially on microfinance institutions through attracting deposits from the population, and on insurance companies that require better governance, transparency of ownership structure and financial capacity building. Finally, the continuous implementation of the program could be affected by the parliamentary elections at the end of this year, especially in terms of the political commitment to continue the reforms.

4.2. The European Union Association Agreement

In June this year, four years have passed since the signing of the Association Agreement between Moldova and the European Union. Along with other areas, the Agreement provides for a comprehensive harmonization of the European regulatory framework for financial services, including the banking, insurance and capital markets sectors. The aim of these reforms is to create secure and efficient financial markets for consumers and systemically stable for the whole economy. To this end, the Agreement provides for the gradual transposition (largely within three years) into national legislation of about 40 European Directives and Regulations included in Annex XXVIII-A "Financial Services". At the same time, there is no strategic planning document to individually and clearly sum up the financial system reforms, as they are found in the AA Implementation National Action Plan that covers all the sectors specified by the Agreement.

market regulators (NBM and NCFM) and 38 to law enforcement bodies. The most significant share is held by the banking sector, namely, the 11 banking institutions covering about 99.6% of the total forms received.

The reforms initiated in the context of the AA aim for the banking sector to align with Basel III standards, for the insurance market to transpose the Solvency II regime, and for the capital market to align with MiFID. If for the banking sector the implementation of European rules appears to be a pressing necessity, then for sectors with limited development this is much more difficult, but at the same time necessary in order to build a functioning market economy. This is also reflected in the pace of transposing legislation that goes faster for the banking sector than for other sectors. Moreover, as the European financial legislation also undergoes a modernization process, the transposition process goes beyond the acts expressly provided for in the Agreement and seeks to harmonize national legislation in accordance with the latest European acts ("*dynamic approximation*").

Broadly speaking, the transposition of European legislation in the field of financial services corresponds to the timetable assumed with the signing of the AA. Thus, from the end of 2017 until the middle of 2018, a number of legislative acts transposing some of the most important actions included in Annex XXVIII-A to the Agreement were adopted. However, for the full effect of these laws, the process of elaboration and implementation of the secondary normative acts needs to be activated, only this way not only the quantitative transposition of the provisions of the Agreement, but also the qualitative one will be ensured. Thus, we can mention here the Law on money laundering and terrorism financing prevention and combating¹³, the Law on bank activity and the Law on the additional supervision of banks, insurers/reinsurers and investment companies belonging to a financial conglomerate¹⁴. Also, for the immediately following period, it is envisaged to activate the insurance reforms requiring a new framework law for this sector that will transpose the Directive 2009/138/EC on taking up and pursuing an insurance activity, a document which includes the Solvency II regime. At the same time, several other actions remain to be achieved, including the reform of the banking sector deposit guarantee scheme (Directive 94/19/EC), the adoption of the regulatory framework for credit rating agencies (EU Regulation 1060/2009) or capital market regulations (private pensions, investment funds, securities issuers).

5. Financial intermediation

In 2018, the financial system continues to be characterized by a decreasing level of financial intermediation but with opposite developments at sector level. Overall, the financial system has a modest contribution to economic recovery, with the share of credits and loans in the GDP being the lowest in the last 10 years. Against the backdrop of large-scale reforms that have tightened bank activity conditions, bank lending tends to contract, leaving space for non-bank financial sector competitors. There is also a tendency to target lending resources to non-productive sectors, such as consumer loans accessed by individuals or mortgage-backed real estate loans. Against this background, new risks tend to occur, including the possibility of population over-indebtedness, abusive lending practices, or reduced interest on the part of banks to take risks.

5.1. Financial services consumer protection

With the increasing demand for loans and bank credits from individuals, a number of risks to consumer protection and population over-indebtedness are starting to manifest more and more actively. Over the recent years, both the bank credit and the non-bank lending sectors have evolved strongly and are continuing to grow. On the one hand, individuals for the time being are among the most "*orderly*" clients, with the non-performing rate for this segment being one of the lowest (below 5% for consumer loans granted by banks). On the other hand, banking reform and constraints in the lending process to legal entities focus the bankers' attention towards the segment of individuals. However, unlike most legal entities that have at least one financially-trained accountant, the segment of individuals remains much more limited in terms of

¹³ Law Nr. 308 as of 22.12.2017 on money laundry and terrorism financing combating and prevention transposes the Directive (UE) 2015/849 of the EP and the Council as of 20 May 2015 on prevention of the use of the financial system for the purposes of money laundering or terrorist financing

¹⁴ Law Nr. 250 as of 01.12.2017 on additional supervision of banks, insurers/reinsurers and investment companies belonging to a financial conglomerate

financial and legal knowledge specific to credit contracts. Under these circumstances, banks, and microfinance companies especially, resort to occasionally abusive crediting practices or provide insufficient information to customers so that they cannot make a real assessment of the costs to be borne.

For individual credit consumers, the complex nature of credit activity generates difficulties in understanding and evaluating the real cost of a loan. Even if there is an agency that focuses on consumer protection¹⁵, it is little known among the population and does not record any interventions in the financial services market. Moreover, although there is a law on consumer credits¹⁶, it is little known among the population and key provisions are often violated in the lending process. Most often, there is a low transparency of the contractual clauses and advertised requirements that do not include sufficient information to thoroughly analyse the best loans - either they are not explained well enough by the lending officers, or the contracts cannot be accessed until the moment when the individual receives the money. Practically, the most relevant indicator (effective annual rate of interest – EAR) that includes all the credit costs and expresses them in a single figure, and which is a useful tool in comparing different loan offers, is not always accessible to consumers. It is often missing from the advertised information, or it is not presented neither in the same visual field, nor with the same font size.

5.2. The “Prima casă” Program (first home)

Following the model of other countries, the Moldovan Government launched a state program to support the acquisition of a first home for young people. Launched on March 26, the state-run “First Home” program involves a state guarantee of 50% of the credit balance. Even if it has a social objective, i.e. the providing housing for young people, the eligibility conditions are quite extensive and cover persons up to 45 years of age who did not own property exclusively or jointly with the spouse during the last 12 months. This implies that for some beneficiaries it may actually not be the very first home, it being known that Moldovans see an investment opportunity in the real estate sector where profitability continues to be higher than that of bank deposits. Thus, there is a channelling of financial resources to sectors that are not necessarily strategic for the economy, which could later result in unhealthy crediting with implications for public finances.

In mid-May 2018, political decision-makers announced the extension of the program and the Ministry of Finance's compensation of 50% of the payments associated with real estate loans contracted by state employees. In addition to the fact that this initiative has a strong electoral character and creates significant discrimination grounds for employees in other sectors of the economy who will not receive any compensation, the elements of the program come to further stimulate the demand for mortgage loans that are not at all easy for bank activity in time. Similar programs in other countries have created a situation where banks neglect standard housing credits and even other types of credits, emphasizing and favouring the applications ensured by state guarantees. Also, as regards strengthening the motivated mechanisms of civil servants, it must be primarily based on the rethinking of the wage mechanism in the public sector, which should be, on one hand, more transparent, and on the other hand based on performance indicators so that competent civil servants are compensated more generously.

Moreover, a new program extension was announced in July this year by the possibility of compensating credit associated payments for families with many children even up to 100%. Seen more as an electoral measure, it tends to have a limited real effect in the context of an uncertain supply of additional resources. Moreover, being a long-term credit, in the face of macroeconomic imbalances (e.g. high inflation), this program could become a risk factor for both the banking sector and the state budget, not even considering the individuals for whom the monthly burden could on the contrary determine them to leave the country for a higher income. Last but not least, the social problems, however stringent they are, should be solved through the social protection system that provides certain facilities for people with many children. The attention of

¹⁵ Consumer Protection and Market Surveillance Agency

¹⁶ Law Nr. 202 as of 12.07.2013 on loan contracts for consumers

the political environment should be oriented rather towards economic development policies that bring additional income, including to the social protection system.

6. The bank fraud investigation process

More than three years after the Moldovan banking sector was defrauded, the banking crisis events picture begins to have an outline. It is becoming increasingly clear that, in fact, the underlying element of the crisis is the huge fraud extended to almost the entire banking system in order to give the impression of a systemic crisis. Also, the existence of transnational groups and sophisticated money-laundering mechanisms on our country territory has facilitated the transfer of the fraudulent money outside of the country, thus ending the final stage of the bank fraud. It is only from this moment that the systemic banking crisis, which involves the lack of several billions of Lei from the banking circuit of the country, actually starts. At the limit of the situation created, it was decided as a last resort to secretly grant government-guaranteed emergency credits by the with subsequent conversion into state debt in the case of failure to honour payment obligations. Although the actions taken by the authorities to stabilize the situation became known much later, November 2014 will remain a black stain for both the domestic banking sector and the political class at that time, as well as a long-lasting memory for the country population and budget. Lack of high-level coordination, shortcomings in bank oversight, poor money flow monitoring, as well as the political disputes at that time were just a few of the key elements that allowed the defrauding of three banks (further BC Banca de Economii, BC Unibank and BC Banca Socială) and misappropriation of billions of Lei by ill-intended factors.

In order to establish a clear chronological picture of the defrauding stages of the three banks, responsible persons and beneficiaries of the fraud, NBM hired Kroll in the external investigation process. On December 21, 2017, NBM published the detailed synthesis of the second investigation report of Kroll and Steptoe & Johnson. The document complements the Kroll 1 report and looks at exposures of defrauded banks during 2012-2014, the association of the Shor group with the respective banks' shareholders, the money laundering mechanisms and the destination of fraudulent funds. According to the investigation reports presented in easy to understand terms, the bank fraud can be described in 6 steps and clear distinct elements which, viewed individually, do not necessarily imply any fraudulent violations or intentions, and viewed as a whole provide a clear picture of the phenomenon we know as "theft of the billion". Annex 1 presents the bank fraud phases in chronological order, and Box 1 briefly presents the 6 steps of the bank fraud.

Box 1. Stages of the 2012 - 2014 bank fraud

- i. **Ensuring ownership of the three banks** - significant change of shareholder structure that led to the entry of front persons and affiliated companies acting concertedly for the benefit of the Shor group;
- ii. **Taking over total control over the three banks** - replacing members of management bodies with persons affiliated and controlled by the Shor group;
- iii. **Channelling lending resources to a single group** - granting credits primarily and predominantly to entities affiliated to the Shor group;
- iv. **Ensuring necessary liquidity** - attracting additional liquidity from other commercial banks or from the public finance system;
- v. **Applying money laundering mechanisms** - concealing the route and destination of funds through offshore jurisdictions;
- vi. **Directing the diverted funds to multiple destinations and for various purposes** - the funds embezzled from the three banks were not reimbursed but used for other purposes.

Source: Author's compilation based on the Kroll reports

This June, the General Prosecutor's Office published a strategy for recovering the money stolen from the three banks. Being a document to rather justify the continuation of investigations, it tries to determine the actions of the responsible bodies in the recovery phase of misappropriated funds, aimed at identifying the people who benefited from the stolen

money, identifying the route of the money and establishing the final destination, and their recovery respectively. Thus, the purpose is to recover the financial means in the maximum possible amount in the amount for which state securities were issued, i.e. MDL 13.34 bln. At the same time, this amount is to be decreased by the value of means to be recovered by NBM as a result of the BEM, BS and UB liquidation, amounting to approximately MDL 2.6 bln., or in other words, the amount of collateral associated with the loans granted before 2012 that is on the balance of the three banks. In these conditions, The Anticorruption Prosecutor's Office and the ACGR have the objective to recover MDL 10.7 bln.

Developed so late from the events of November 2014, the Strategy somewhat leaves the impression that the authorities have waited for clarity in Kroll's investigations to be able to put together a complete picture of the bank fraud. Thus, a very important element the Strategy brings and which is not covered by the Kroll investigation is the 2007 - 2012 period when BEM granted a consistent amount of non-performing loans. Accordingly, the authorities confirm that they assessed the actual value of credits granted before 2012 and which were not reimbursed, i.e. before the Shor group took over control. Taking into account that the amount is estimated at about MDL 3.2 bln. and is a very important factor that influenced the subsequent start of the events, it is important to clarify the situation in that given period, namely who the beneficiaries of these loans were.

Also, another crucial element is the period of November 2014, namely the moment it was decided that the Government would guarantee the credits provided by NBM and the moment when NBM applied control over BEM (special administration). As we can deduce from the transcript of the secret Government meeting on November 7, 2014, as confirmed in the Strategy, the issue of state guarantees for possible emergency loans granted by the NBM was to represent a temporary cautionary mechanism applicable only in case systemic crisis is triggered. Thus, although it was known what the situation in the three banks was, as well as the formula for how they would be saved, between November 7 - 27, 2014 (20 days) there no measures were undertaken towards minimizing damage and securing existing funds, amplifying respectively the elements of a systemic crisis. Virtually aware of the possible mechanism for guaranteeing emergency credits and with a strong moral hazard, the fraudulent lending and fund diversion have continued. In this respect, additional liquidity from the banking sector was attracted, namely deposits from four other commercial banks¹⁷ that seem to have no economic reasoning. With respect to the amounts stolen from the banking system during this period, Kroll identified the amount of MDL 5 bln., amount confirmed by the Prosecutor's Office as part of the strategy. Annex 2 graphically describes the national banking system defrauding process by pointing out the stages regarding which still many questions pend.

The process of recovering the money stolen from the banking system and the process of redemption of government bonds issued in order for the Ministry of Finance to execute the payment obligations are two totally different processes. Even if there are statements in the public space that no public money was used to recover the billion, it is false. In fact, in October 2017, Ministry of Finance transferred to the NBM the first instalment for redemption of bonds issued in amount of MDL 668 million, representing the redemption of those with the circulation term of one year (MDL 50 million) plus the interest for the entire amount of bonds issued in 2016 (MDL 618 million). Thus, taking into account that from the liquidation of the three banks, until October 2017, MoF recovered only MDL 274.6 million, the difference of MDL 393 million (668 - 274.6) represents public money from the state budget. Theoretically, at some point, the reverse may also be valid, the rate of recovery may exceed the one in the bond redemption schedule, in which case public money is recovered. Such a situation is possible even this year once the assets seized in the closed court cases are been sold, the value being transferred to the state.

¹⁷ Between November 17 and 24, 2014, BC Victoriabank, BC Moldindconbank, BC Moldova Agroindbank and BC EuroCreditBank have daily placed significant financial resources at the Banca de Economii, the maximum amount was of 2,3 MDL bln. reached on November 24.

7. Final conclusions and recommendations

The size, severity and public nature of recent bank frauds presses on the need to continue reforms in the national financial system and to rethink the model in which financial institutions operate. Considering that any crisis implies a broad process of reflection on what had happened, the reforms aim at correcting the business model of national financial institutions and emphasizing their role in effectively supporting the national economy and the personal projects of the population. Also, an important aspect revealed by the banking crisis and which tends to be revised is the capacity of the state institutions to ensure dialogue, consensus and intervention capacity when deviations are detected. However, as demonstrated by the latest developments of the EU macro-financial assistance, strengthening the financial system individually and isolated from other key areas cannot fully guarantee the irreversibility of undertaken reforms. In this context, we can state that only on the background of balanced and correlated policies between all spheres of economic and social life, respecting democratic principles and the rule of law, the confidence in the financial system can be restored and the positive perspectives for the national economy can be regained.

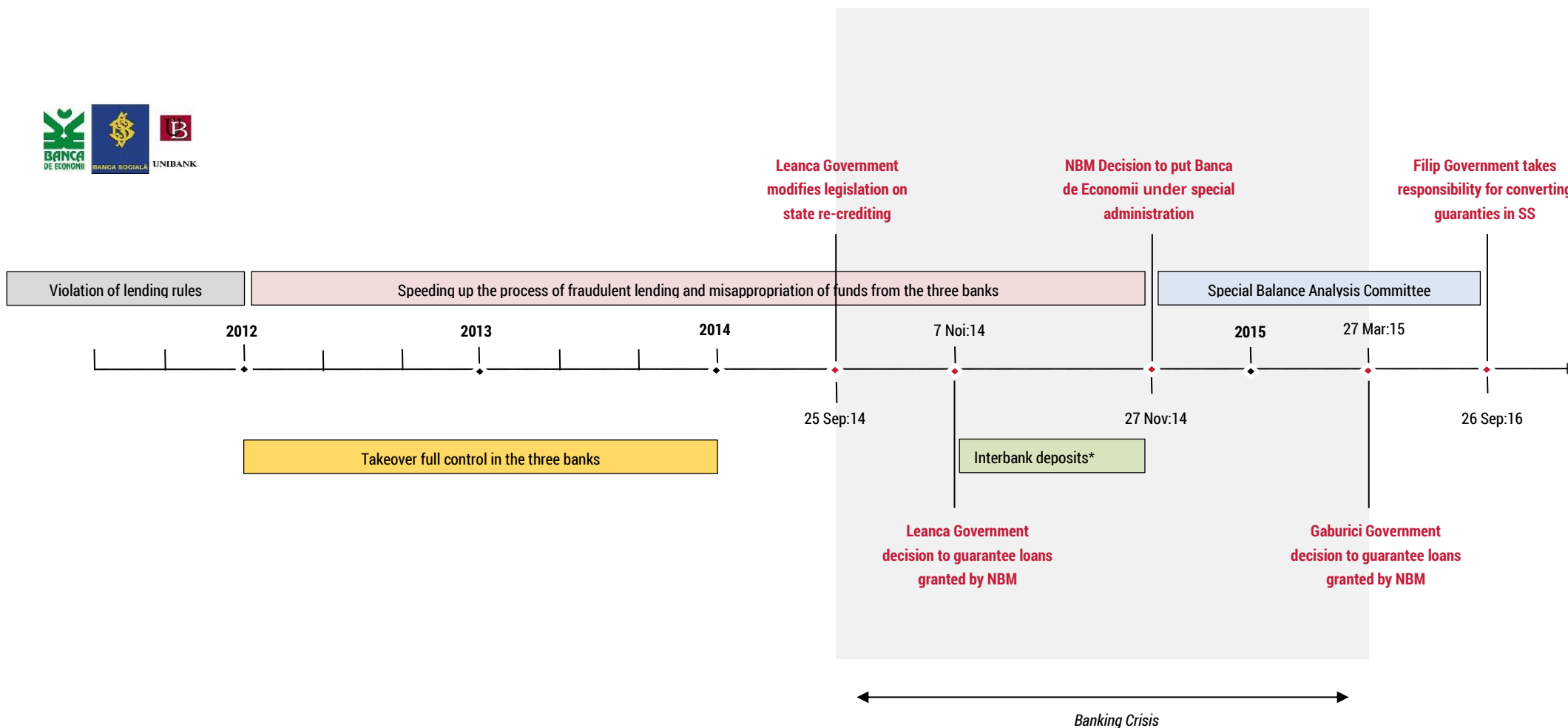
The need for uniform rules for all financial service providers extends the reform process to other sectors less regulated to date. Thus, for the microfinance, leasing or insurance sectors, the same reform vision based on principles of transparency, sound governance, adequate risk management or accountability is outlined. Even so, the banking sector reform is advancing at a much faster pace, which leads to the emergence of different levels of regulation for institutions that essentially perform the same function – to intermediate the temporarily available financial resources from those who save money, to those who invest. In this context, the following recommendations aim at supplementing and streamlining reform actions and relate to:

- **Accelerating reforms in the non-banking financial sector** – in order to guarantee a common development approach for all financial market sectors, both non-bank lending organizations and insurance companies need to implement the same activity principles as the banks. Thus, the "fit & proper" competence and integrity standards, the principles of corporate governance with clear definition of the responsibilities of the management bodies, the transparency of the shareholder structure, or the sanctions regime to discourage any intentions of fraud, need to be transposed into the specific regulatory framework
- **Increasing the financial service consumer level of protection** – in order to strengthen competition in financial services, to protect consumers and avoid the risk of indebtedness, the mediation process and especially the credit cost should be as transparent and as understandable as possible. To this end, supervision bodies must ensure that financial institutions provide all the necessary information to clients, especially EAR, so that they can compare the credit cost easily, without having advanced economic training.
- **Reducing informational asymmetry and increasing the role of Credit History Offices** – in order to know the real situation of borrowers, all lending institutions, both banks and the NLO, should be required to provide information to CHO. This is all the more important as there is a tendency to increase the volume of loans granted to individuals, which are often borrowing from multiple sources in order to remain eligible for each of them.
- **Diversifying savings tools accessible to the population** – channelling the savings of the population only in the bank deposits segment creates premises for risk concentration only in the banking sector. At the same time, the national financial market registers a lack of long-term financial instruments that provide the necessary premises for inclusive and lasting economic development. In this respect, increasing the access of private investors to the VMS market can support a high and stable demand for government bonds, diversify the financial sector risks, and ensure an increase of the maturity term of existing financial resources.
- **Adopting an extended strategy to increase access to finance** – initiatives to support access to finance are too fragmented and lacking the necessary coordination so the results are modest. Also, the intermediation process is affected by a series of vulnerabilities that hinder the expansion of crediting to productive sectors of the

economy. This requires a holistic approach that encompasses all institutions with a determining role in the financial system, as well as all lending incentive initiatives. An example in this sense would be the establishment of a Financial Sector Development Committee.

- **Boosting the bank fraud investigation process** – the recent Strategy for the recovery of defrauded goods does not provide a decisive role for the NBM, even if it is the main source of information and relationships with regulators in the jurisdictions where the money was transferred. Moreover, although it played a decisive role in investigating the way in which the bank fraud has been committed, the Kroll Investigation Agency appears to be left out as well. Under these circumstances, both the NBM and Kroll must be active parts in this process in order to accelerate the investigation and increase the credibility of the actions taken.

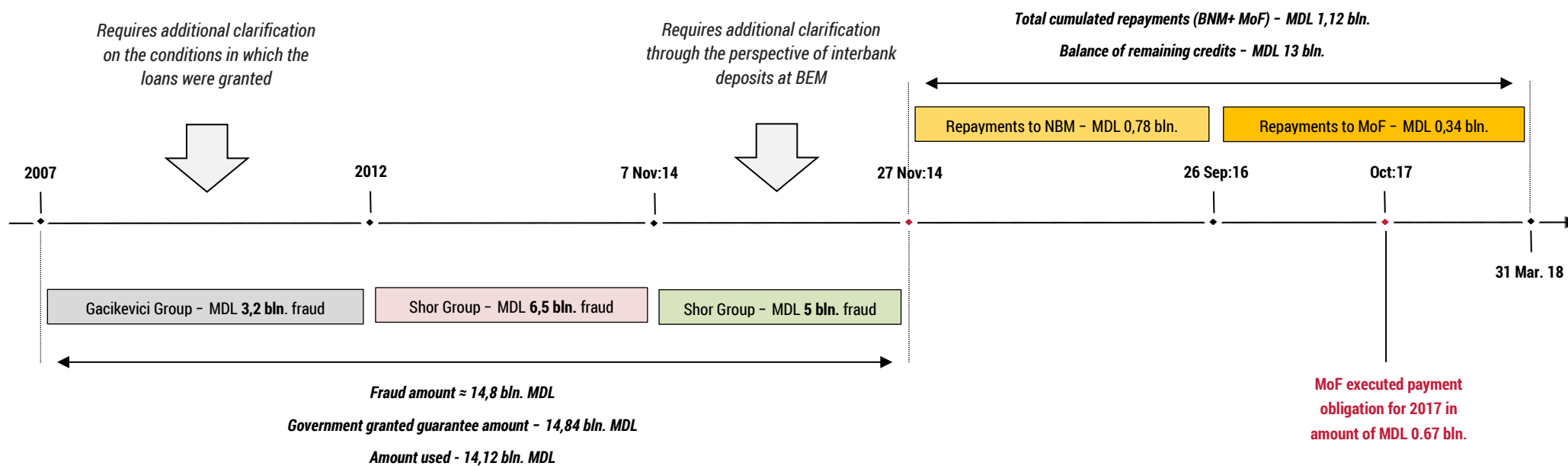
Annex 1. The stages of the fraud and the banking crisis



Compilation of the author based on the Kroll reports and Government decisions regarding state guarantees

* Between November 17 and 24, 2014, BC Victoriabank, BC Moldindconbank, BC MoldovaAgroindbank and BC EuroCreditBank have daily placed significant financial resources at Banca de Economii

Annex 2. The process of stealing the financial resources and the subsequent recovery process



Compilation of the author based on the Kroll reports and the Strategy for recovering funds from the three fraudulent banks